No. [redacted] 41

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1968

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

vs.

NATIONAL SECURITIES, INC., *et al,*
Respondent.

RESPONSE TO PETITION FOR CERTIORARI

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TABLE OF CASES AND AUTHORITIES CITED

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The respondents request that the petition for certiorari in this matter be denied.

Opinions Below

The opinion of the District Court is reported at 252 F. Supp. 623, and the opinion of the Court of Appeals is reported at 387 F.2d 25.

Jurisdiction

The judgment of the Court of Appeals was entered on November 14, 1967. This Court has jurisdiction under 28 U.S.C. § 1254(1).

Question Presented

We cannot agree that the "question presented" as offered by the Government is the question actually presented to and decided by the court below. We therefore restate the question as follows:

Whether § 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 issued thereunder, read in the light of the McCarran-Ferguson Act, apply to allegedly false and misleading statements made in soliciting stockholder consents to a merger of insurance companies where the same matters have been before the State Director of Insurance who has approved the merger.

Statutes and Rule Involved

The relevant provisions of the McCarran-Ferguson Act, 59 Stat. 33-34, 15 U.S.C. §§ 1011-1015; § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b), and Rule 10b-5 of the General Rules and Regulations under the Securities Exchange Act of 1934, 17 C.F.R. 240.10b-5; the relevant provisions of the Securities Acts Amendments of 1964, 78 Stat. 565 (1964); and of the several applicable provisions of the statutes of Arizona are set forth in App. A.

Statement

In April, 1964, National Securities, Inc. (National Securities) held a controlling interest in an Arizona insurance company, National Life and Casualty Company (National Life). National Securities bought a substantial block of stock in a second Arizona insurance company, Producers Life Insurance Company (Producers). Neither National Life nor Producers was registered on

any national securities exchange, and their stock was traded over the counter.

Subsequent to the 1964 purchase, National Securities proposed a merger of the two insurance companies. A vigorous proxy fight ocurred within Producers as to whether or not to agree to the merger, and there was a hardhitting proxy solicitation campaign, with much solicitation material (R. 567, *et seq., passim;* R. 620).

On March 30, 1965, the SEC filed this action and obtained an *ex parte* restraining order (R. 108-11), the practical effect of which was to enjoin the merger. Speaking generally, the complaint was that there had been errors and omissions in the proxy solicitations (R. 9-11).

Proceedings on the SEC's application for a preliminary injunction were held on April 16, 1965. National Securities challenged the jurisdiction of the court, denied all allegations of any misleading statements, and also challenged the entire complaint as failing to state a claim. The District Court, on hearing, struck from the temporary restraining order all language which would preclude the merger (Order, R. 292).

In making this order, the District Court required a stipulation that if the stockholders voted for the merger, the matter would not be presented to the Arizona Director of Insurance for at least a week so that protests could be filed; and it was further stipulated that the company would give the SEC telegraphic notice at least one week before the matter would be presented to the Arizona Director so that the SEC might take any action it desired.

The stockholders then voted and the result was overwhelmingly in favor of the merger (R. 437-38). On April 27, 1965, the SEC was thus advised, and was told that

the merger would be presented to the Arizona Director. The Commission did not move for any stay of the cancellation of the operative portions of the temporary restraining order, nor did it apply to any higher court for relief. Instead, on April 28, the Commission wrote the Arizona Director of Insurance stating its view of the illegality of the proxy solicitation and forwarding to the Arizona Director all of the pleadings and evidentiary materials which had been before the Federal District Court.*

Under Arizona law, as will be more fully particularized below, a merger of insurance companies can occur only upon approval by the Arizona Director of Insurance, who is expressly required to consider stockholder as well as policyholder interests. Having had the opportunity to consider these matters, the Arizona Director of Insurance approved the merger (R. 800), and the surviving insurance company has since functioned as National Producers Life Insurance Company (National Producers).

On August 1, 1965, the SEC filed its amended and supplemental complaint for injunction (R. 423). The merger having been accomplished, it could no longer be

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* These two paragraphs, showing the stipulation and the SEC's submission of the materials to the Arizona Director of Insurance, raise a problem of the record. The stipulation was set forth orally in the partial transcript of proceedings of April 16, 1965, pp. 15, 50-51; and it was confirmed in full detail, with references to all of the materials submitted by the SEC to the Arizona Director of Insurance in its own motion for reopening of the hearing on the preliminary injunction filed July 12, 1965, R. 390-97. These pages, though in the actual record, were not included in the designation which the SEC made for duplication of the record in the court below. We have therefore applied to have the original papers transmitted to this Court from the Court of Appeals in accordance with Rule 12(3), Rules of the Supreme Court.

enjoined; and the prayer for relief in essence called upon the defendants to undo it.

There were a number of issues before the District Court. Wholly apart from the McCarran Act question, the District Court adopted two independent grounds for decision in favor of the company.

1. The District Court found that the acts complained of would have fallen within the prohibitions of the proxy-solicitation-antifraud provision of § 14(a) of the 1934 Act but for the fact that the stock of the insurance company involved had never been registered on any national securities exchange; it found that the coverage of that section of the Act would not apply to the company until 1966, by virtue of the Act of August 20, 1964; and then only if the company were not within an exemption created by that Act. See Findings 4 and 5, set forth in the Government brief at p. 20a.

2. The District Court found that the remedy sought by the Commission was outside the scope of available relief provided in § 21(e) of the 1934 Act. (Government brief, p. 23a).

As a primary and independent ground of decision, the trial court found that the action was barred by the McCarran Act in that it would at least "impair" if not "invalidate" or "supersede" the laws of the State of Arizona regulating the business of insurance.

The Court of Appeals found it unnecessary to pass on any of the grounds other than the McCarran Act, and affirmed. However, it invoked the conclusions of the District Court on § 14(a) in respect to the prematurity of the SEC's attempt to invoke this power. The details of the Court of Appeals opinion will be considered in the Argument following.

Reasons for Denying the Writ

I. *Introduction.*

As we have noted in the Question Presented, this is one of those rare cases in which we must differ from the Government as to what the matter is about. The Government states the question in the broad, putting it generally as to whether the antifraud provisions of the Securities Exchange Act of 1934 can ever be applicable to false and misleading statements allegedly made in soliciting stockholder consents to a merger of insurance companies. But the District Court, and the Court of Appeals, and we, see the question more narrowly. As the Court of Appeals noted, Senator McCarran had said that "Congress held out an invitation to the states to deal affirmatively and effectively with those activities and practices of the insurance business which might otherwise be subject to federal regulation." Thereupon, Arizona expressly passed its little McCarran Act which did specify and govern illegal practices of insurance companies; A.R.S. § 20-441. Moreover, the Arizona Insurance Code expressly governs the conditions and standards of mergers of insurance companies, and puts as one of the issues to be determined by the State Director of Insurance whether the plan is "inequitable to the stockholders of any domestic insurer involved," and also whether it is contrary to law; A.R.S. § 20-731. The laws to which it might theoretically be contrary are Arizona fraud laws broad enough to cover misleading financial statements in proxy solicitations, A.R.S. § 20-441, 443(3), 444. As the Court of Appeals found:

> "The State of Arizona has affirmatively asserted its power to regulate the merger of insurance companies. It has not merely deemed such mergers to be legal,

nor perfunctorily incorporated by reference its corporate merger provisions, but has set out additional standards and empowered a state agent to enforce them."

We are dealing with a plain question of local law, traditionally left to the lower courts to decide, *Spiegel's Estate* v. *Comm'r*, 335 U.S. 701, 707-08, 69 S. Ct. 301, 93 L. Ed. 330 (1949), but in this case obvious on the face of the statute.

In short, we have had an express, meditated decision by the State authorities of Arizona that these two insurance companies could merge and become one insurance company. The SEC had full opportunity to present these matters to the State authorities and, in fact, did so. The issue therefore is whether, when a state does make every effort to utilize all of the power over insurance companies which it has under the McCarran Act, it is to be allowed to do so.

II. *There is No Conflict of Decisions.*

No conflict is suggested, nor could there be such a suggestion. So nearly as has been discovered, there is no case dealing at all, in any direct sense, with the application of the McCarran Act to insurance company mergers. The spirit of the McCarran Act is recognized in the majority opinion in *Securities and Exchange Commission* v. *Variable Annuity Ins. Co.*, 359 U.S. 65, 68-69, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959), in which Justice Douglas for the Court said:

"We start with a reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements or transactions that are tailored to meet state

requirements. When the State speaks in the field of 'insurance,' they speak with the authority of a long tradition. For the regulation of 'insurance,' though within the ambit of federal power, *(United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 64 S. Ct. 1162, 88 L. Ed. 1440), has traditionally been under the control of the States." 359 U.S. at 68-69.

The legislative history is developed in the dissenting opinion in that same case, in language which we think a majority would equally accept, see 359 U.S. at 99, as follows:

> "In 1944, this Court removed the supposed constitutional basis for exemption of insurance by holding, in United States v. South-Eastern Underwriters Ass'n, supra, that the business of insurance was subject to federal regulation under the commerce power. Congress was quick to respond. It forthwith enacted the McCarran Act, 59 Stat. 33, 15 U.S.C. §§ 1011-1015, 15 U.S.C.A. §§ 1011-1015, which on its face demonstrates the purpose 'broadly to give support to the existing and future state systems for regulating and taxing the business of insurance.' *Prudential Insurance Co. v. Benjamin, supra*, 328 U.S. at page 429, 66 S. Ct. at page 1155, and 'to assure that existing state power to regulate insurance would continue.' *Wilburn Boat Co. v. Fireman's Fund Ins. Co., supra*, 348 U.S. at page 319, 75 S. Ct. at page 373. Thus, rather than encouraging Congress to enter the field of insurance, the South-Eastern decision spurred reiteration of its undeviating policy of abstention."

See also *North Little Rock Transp. Co. v. Casualty Reciprocal Exch.*, 181 F.2d 174 (8th Cir. 1950), upholding state rating bureaus in relation to the Sherman Act; *Federal Trade Commission v. National Casualty Co.*, 357 U.S. 560, 564, 78 S. Ct. 1260, 2 L. Ed. 2d 1540 (1958), on insurance company advertising in relation to the Federal

Trade Commission. As this Court said in the case just cited, "Petitioner does not argue that the statutory provisions here under review were mere pretense." The Court of Appeals has obviously echoed the same thought in the instant case by stressing that the Arizona regulation is substantial and not perfunctory.

We are not dealing with some question of Commission jurisdiction where an insurance company issues securities as well as sells insurance contracts; *cf. SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202, 87 S. Ct. 1557, 18 L. Ed. 2d 673 (1967). Here we have nothing tangential or remote from the central function of insurance regulation. In the instant case, we deal with the bedrock question of the existence of an insurance company. Here these two Arizona insurance companies could merge and become one Arizona insurance company, or they could not. The determination of this question is at the very heart of the state regulatory function. As the Fourth Circuit has said, "Unless a Federal statute is made specifically applicable to the insurance business, it shall not 'invalidate, impair or supersede' any State insurance law." *Allstate Ins. Co.* v. *Lanier*, 361 F.2d 870 (4th Cir. 1966). The guiding principle is that "Where there is an applicable state statute, the federal Legislation does not apply." *Transnational Ins. Co.* v. *Rosenlund*, 261 F. Supp. 12, 26 (D. Ore. 1966).*

There is no conflict.

III. *This is an Isolated Question, and One Which Will Probably Never Arise Again in the United States.*

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* *Cf. United States* v. *Sylvanus*, 192 F.2d 96 (7th Cir. 1951), cert. denied, 342 U.S. 943, 72 S. Ct. 554, 96 L. Ed. 701 (1952), in which the mail fraud act was held applicable to certain insurance policies, there being no suggestion that any state law was invalidated, impaired, or superseded.

There is no good in talking, as the Government does, about the volume of insurance company mergers. The question is, how many of them arise under anything like a legal system such as that operative here. The answer is very few; and, in any case, the relevant Act of Congress has been materially changed since this controversy arose.

1. The Government begins its argument with the observation that, "The traditional thrust of State insurance regulation has been the protection of policyholders, not stockholders." So far as mergers are concerned, this is only partially true. Ten states either have no or very limited insurance company merger provisions. Twenty-seven states require the approval of the insurance commissioner for mergers, but without specific mention of the rights of stockholders. (See App. B.)

Thirteen states, of which Arizona is one, require consideration of stockholder interest on mergers and also have antifraud provisions; see App. B. It follows that even theoretically a McCarran Act problem of the present sort could arise only in one of these thirteen states; and we do not know whether in these states such merger matters would in actual practice be seriously considered.

But we do know that we are not cited to one single illustration in any court or in any administrative agency, in which any McCarran-merger problem has ever arisen, except this case. It is indisputably unique, precisely what certiorari is not for; see illustratively the remarks of Chief Justice Vinson quoted in *R. Stern & E. Gressman, Supreme Court Practice* 120-21 (3d ed. 1962).

2. Not only has this question not arisen in the past, but because of a major change of law, it cannot arise in the future. While the particular case is still viable, the

legal issue has become virtually moot. Where the case depends on statutes which have since been changed, this Court would very rarely take the case even if there were a conflict, *R. Stern & E. Gressman, supra*, at 126-27.

This is an action to nullify a merger, allegedly because of improper proxy solicitations, brought under § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j, and Rule 10b-5, issued under that Act (see App. A). On their face, at least, these sources do not deal with proxy solicitation at all. The proxy section is § 14(a) of the Act, 15 U.S.C. § 78n, which prior to the 1964 amendment made it illegal, in violation of the Rules of the Commission, to solicit proxies in respect of any security registered on any national securities exchange. The Commission could not and did not assert jurisdiction under the proxy rules over proxy solicitations relating to corporations whose securities were traded on the over-the-counter market; and most of the insurance companies, including these, were not registered on the exchanges.

Section 14 was extensively amended in 1964, 78 Stat. 569 (App. A). The amendment, which took effect in 1966, extended proxy controls to companies whose securities are sold over the counter, but exempted insurance companies where a substantially equivalent state regulation is in effect. (15 U.S.C. § 78*l*(2)(G), App. A). Upon the passage of that Act, the National Association of Insurance Commissioners prepared uniform proxy regulations for use by the insurance commissioners of each state, and all fifty states have now adopted either regulations or statutes to this general effect; see 2 CCH Fed. Sec. L. Rep., para. 23,310. Arizona thereupon adopted a comprehensive statute referring explicitly to the 1964

amendment, authorizing appropriate rulemaking, and regulating insider trading by officers, directors and principal stockholders; A.R.S. §§ 20-143 and 20-726.01. In pursuance of that statute, the Insurance Director issued general Rule No. 66-12 ("Regulations Regarding Proxies, Consents and Authorizations and Domestic Stock Insurers"), a regulation of some 5,000 words dovetailing into SEC controls.

(a) We do not believe that Rule 10b-5 ever did have any application to proxy solicitations and that this has always been a Rule 14(a) matter. The District Judge apparently thought so. See paras. 4 and 5 of his order, which the Court of Appeals quotes.* Certainly, as note 6 to the Court of Appeals opinion shows, the House Committee Report on the 1964 Amendments assumed that, in the light of the McCarran Act, the states should have the first opportunity to regulate proxy solicitations. This is overwhelmingly evident in the full House Report, and we attach all relevant material from that Report as App. C. The Commission in so many words told Congress that the amendment was needed, among other things, to deal with insurance mergers.** Nonetheless, Congress did expressly exempt insurance companies where the states undertook regulation.

(b) But the question just mentioned is no longer worth

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* In *J. I. Case Co. v. Borak*, 377 U.S. 426, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964), plaintiff alleged misleading proxy solicitations resting on both § 10(b) and § 14(a). The District Court held that § 10(b) did not apply to proxy solicitations, this being a § 14(a) matter. The Court held that § 14(a) gave a remedy, and did not consider the § 10(b) question.

** H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 3, at 40-41 (1964). Speaking of insurance companies, the Commission listed "mergers" as one of the examples of inadequate proxy controls.

answering. Whatever may have been the law as to proxy solicitations and mergers when this case arose, it is vastly different now. There will never again be a case on the validity and proprietary of proxy solicitations for insurance company mergers in the absence of express state regulations because now, by the virtual direction of Congress, every state has such regulations. A decision of the point would not even dispose of this one isolated case, because there remain the other independent grounds, two of which were adopted by the District Court, for reaching the same result.

Conclusion

We cannot conceive how it would be possible more totally to "invalidate, impair, or supersede" a state insurance law than to determine that an insurance company may not exist when the State Director of Insurance has said that it may. This case is of course important to the parties, as all cases are; but in view of the total absence of conflict and the complete change in the law, it does not belong on the Supreme Court docket.

Respectfully submitted,

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